Bulletin 381

CONSUMER CREDIT

Agricultural Extension Service

The Ohio State University

SALE!

PAY NOTHING DOWN

NO CASH DOWN

EASY TERMS

Finance Bargains

LOANS!

DOLLARS

CASH OR CREDIT

NO MONEY DOWN
3 YEARS TO PAY

EXTRA LIBERAL CREDIT TERMS!

LOCAL BANK FINANCING!

EARN 6%

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consumer credit

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The all-inclusive definition of consumer credit is "money or purchasing power extended by lending agencies or dealers to consumers." Thus, money borrowed for buying a home over a long period of time is consumer credit. However, in this bulletin we will discuss only shorter term credit, that which must be paid for usually in 1 to 36 months.

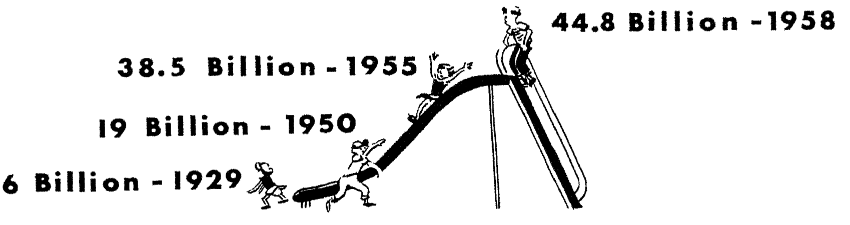
Consumer credit may be purchase or sales credit provided at the place you do your buying. It also may be a cash loan or borrowed credit.

Consumer credit is a means by which many families enjoy a higher level of living than they might otherwise have. They can buy and use such durables as automobiles, household equipment and home furnishings before they have saved enough money to pay cash for them. However, consumer credit is costly, and many families get into money problems by owing too much at too many places.

With a limited money income and savings, consumers can either wait, save and pay less, or pay more and avoid waiting.

trends in consumer credit

There has been a tremendous growth in the amount of credit and the number of families using it. Outstanding credit in January, 1958, was about $44.8 billion compared to $38.5 billion in 1955, $19 billion in 1950, $8 billion in 1940 and $6 billion in 1929. There has also been an increase in prices we pay and in disposable income (that left after income tax is paid).



On a per person basis and in dollars of the same value, disposable income and total spending for family living were more than half again as high in 1958 as in 1929 or 1940. At the same time, consumer credit outstanding was about three times as great in 1958 as in 1929 and double what it was in 1940. In 1957 consumer credit payments took $14 out of each $100 spent by consumers for family living. In early 1958 they were paying off such debt at an even higher rate.

Many new kinds of goods and services can now be bought on credit. In addition to automobiles, furniture and household equipment, it is possible now to buy travel, college education, hotel rent, meals and other similar items on credit.

Buying from a dealer or merchant on the installment plan creates the largest part of consumer debt. In 1957 it made up more than three-fourths compared to two-thirds in 1940. This increased proportion was due primarily to buying automobiles at "so much down and so much a month." Regular charge accounts are becoming relatively less important as new types of credit take their place.

who uses consumer credit?

Families and individuals with loans to pay off are found in all income groups; all age groups except the very young; among married folks and single ones; couples with children and without, and among workers in all occupations. However, certain groups are more likely than others to use credit.

In the middle income bracket, $4,000 to $7,500, almost two-thirds use credit compared to two-fifths when incomes are under $2,000 or over $10,000. Families with little or no cash or savings are more likely to use credit, but some who could pay off all debts use credit. Families with children are more likely to have debts than those with no children.

Families with more than one earner use credit more than those with only one earner. Skilled workers are most likely to have consumer debt. Next are the semi-skilled, unskilled, service, professional and semi-professional and managerial workers. Least likely to have consumer debt are farm operator families.

why do costs vary?

Consumer credit is not a standard service. Costs may be different each time a family uses it. The rates vary with the size of the loan, nature of the company extending the credit, the guarantee the families can give that they will make payments, and other factors.

On personal loans, many lenders provide insurance on the life of the borrower to protect the lender if the borrower should die. They either cover the cost of life insurance as part of the finance charge or make an additional charge for the insurance.

Some lenders add accident, fire and theft insurance to the cost of financing automobiles and other durable goods. Other automobile dealers may include personal accident, health, hospital and ambulance, towing service, and bail bond insurance.

As a consumer, you need to determine just what you are buying and to separate the cost of insurance and other extras from the costs of the credit.

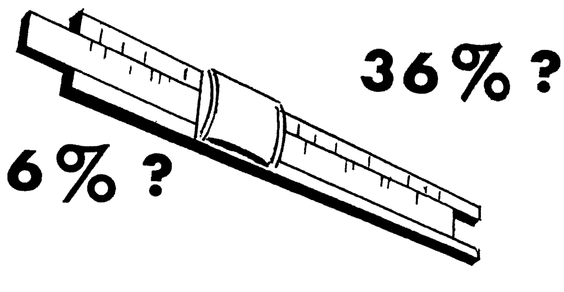
The actual cost of the credit varies, too. Pure interest or the cost of the money itself is a factor. Bad debts and credit losses shove up the cost. The greater the risk the higher the financing charge must be. Expect to pay more if you borrow from sources that make high risk loans and many small loans.

It costs the lender as much to make a small loan as a large one. The cost of making a loan includes investigating credit worthiness of the borrower, collecting, bookkeeping, etc.

Rates are likely to be higher on an old model car than a new one. Also, if a person is a poor credit risk (appears to be lacking in ability or willingness to pay credit obligations) he must expect to pay a higher rate.

how to figure interest charges

Consumers must be able to figure the cost of credit in both dollars and interest rates, if they are to use it wisely. Methods commonly used to state finance charges are add-on, discount and interest on the unpaid balance.



The add-on method is used most often to figure the installment cost of automobiles and other consumer durables. The discount method is used for repair and modernization loans by the Federal Housing Administration and for some personal loans. Interest on the unpaid balance is the method used by consumer finance companies and by credit unions.

If you need to borrow $1,000 on a car for a year at the rate of 6 percent and you pay all of it at the end of the year, the cost would be 6 percent of $1,000, or $60. You would add on the $60 and pay a total of $1,060. The true interest rate would be 6 percent.

If you were to use the discount method to borrow $1,000 at 6 percent, the lender would take off 6 percent of $1,000, or $60, and you would receive only $940 to use for the year. If you need all of the $1,000, then, how do you figure the amount you need to borrow?

When 6 percent of the amount is deducted before you get it, $1,000 is only 94 percent of the amount you need to borrow. To find out how much you need to borrow, divide $1,000 by 94 and multiply the result by 100. The total is $1,063.83. The true interest rate is a bit more than 6 percent. At a given rate, the discount method is always more expensive for the consumer than the add-on.

If you repay the loan in installments, you will have the use of the entire amount for only one month. Each month you have the use of a smaller sum. You have, on the average, about half of the total amount, so the true interest rate is about twice the 6 percent.

This can be illustrated by using $1,000 at 6 percent, too. The first month you would have $1,000. The monthly payments would be $1,000 plus $60 divided by 12, or $88.33. The last month you would owe less than $100 or a monthly average of about $500 throughout the year. This would make the true interest rate about 12 percent.

Changing stated charges into the approximate annual interest rate should help you choose the best method of financing. To do so, one must know three things:

1. The amount of the finance charge. This may be stated. If not, it can be figured as the difference between the total of all payments and the cash price.
2. The amount of the loan or credit extended.
3. The period over which you must pay off the total amount.

There are several methods of computing the "true" interest rate. An accurate one, the constant ratio method, may be illustrated as follows:

Formula

$$\frac{\text{Total finance charge}}{\frac{1}{2}\text{ of original loan}} \times \frac{\text{Number of payments}}{\text{Number of years}} \times \frac{1}{\text{Number of payments} + 1} = \frac{\text{Annual interest}}{\text{Rate}}$$

As an example, a refrigerator priced at $230 cash price can be purchased on time with a $10 down payment and the balance of $220 on time. The carrying charge is $26.50 and payments are $10.50 for 24 months. The last payment is only $5. In this case, the original loan is the cash price minus the down payment. Using the formula to figure the interest, we get the following:

$$\frac{\$26.50}{\tfrac{1}{2}\text{ of }\$220} \times \frac{24}{2} \times \frac{1}{24+1} = 11.5 \text{ percent}$$

Consumers may shop hours for an appliance to get a good deal and then accept any finance charge that is offered. There may be two reasons for this: (1) the difference in cost changes the monthly payment only a relatively small amount, and (2) the consumer is often unaware that differences exist in the finance rates charged by different merchants or sources of credit.

legal limits

Legal limits on charges on loans vary between states. In states with adequate legislation these rates, in terms of simple interest, vary up to 42 percent per year. Ohio has a small loans law, stating that the maximum monthly charge on unpaid principal balance is 3 percent (36 per cent per year) on loans of up to $150; 2 percent of up to $500 and ⅔ of a percent to $1,000.

Ohio also has a law limiting charges on installment sales contacts. The maximum finance charge on the principal balance is $8 per $100 plus 50 cents per month on the first $50 plus 25 cents per month on the next five $50 units.

The lowest credit may not always be best for a particular family. Other factors enter in, such as speed, convenience, privacy, need for financial guidance, type of security, length of contract and number of payments. These factors, along with dealer or lender costs, determine what you get for the interest you pay.

types of consumer credit

Sales or Purchase Credit is provided where buying is done or service is received.

1. Open charge accounts at department stores are usually due at the end of the month. There is no service charge.
2. On revolving charge or budget charge accounts at department stores for clothes, linens, jewelry, etc., the customer sets an amount that he

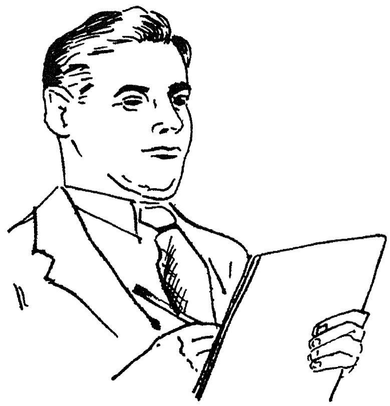
can pay on an account at that store each month. He can then charge up to 12 times that amount. As monthly payments are made, new charges can be made on the account as long as the total is not more than 12 times the monthly payment due. The carrying charges, added to the payment, are usually 1 to 1½ percent per month or 12 to 18 percent per year.

3. On installment credit from the dealer or retailer, the seller may carry the account as a charge or sell the contract to a financing agency. The goods are usually sold on a conditional sales agreement. The seller retains the title and the right to take the item back if payments are not made. In Ohio, adjustments are made so that the consumer may not lose the entire amount that has been paid.
4. Installment sales credit from finance companies is widely used to finance automobile purchases.
5. Service credit is such as may be secured from the doctor, dentist, dry cleaner and utilities. This is similar to a charge account at a store.

Cash Loan or Borrowing Credit. The consumer borrows a sum of money which may or may not be for a specific purchase. Lenders vary as to their demands for security or co-signers and in charges.

Commercial banks, industrial banks set up largely to serve the working man and his family, credit unions which loan to membership groups, and small loan companies are sources of this type of credit. The repayment may be on the installment or lump repayment plan. Banks in particular make loans due in 3, 6 or 12 months.

Life insurance companies will loan up to 95 to 100 percent of the cash surrender value of policies carried with them. The policy is decreased in value by the amount of the outstanding loan in case of the death of the owner. People tend to be lax in paying off such loans and, as a result, the insurance no longer gives protection.



should you use consumer credit?

The use of charge accounts and installment purchases or loans may or may not be advantageous to the consumer. A study of the following possible advantages and disadvantages may help you decide for yourself.

advantages of a charge account

1. It simplifies returning unsatisfactory goods.
2. It helps the shopper establish credit rating.
3. It allows paying for many items with one lump sum.
4. Charge customers receive advance notice of new goods, sales, etc.
5. Monthly payments of itemized purchases may aid in keeping records.
6. Some shopping can be done by mail or phone.
7. It may assure prompt repair or adjustment services.
8. Shopper need not carry large sums of cash.

disadvantages of a charge account

1. It may encourage overspending.
2. Goods may cost more at stores that do not add service charge to accounts.
3. Revolving charge accounts have relatively high interest rates.

advantages of installment buying

1. Permits buyer to use goods while paying for them.
2. Forces savings on those who "can't" save and buy with cash at a lower price.
3. Makes possible buying goods that might be used to increase income.

disadvantages of installment buying

1. Cost has to be high to cover bookkeeping, insurance risks, loss to company.
2. Consumers may commit themselves to more payments than they can meet and still pay current living expenses.

how to use credit wisely

The wise consumer will control his use of credit rather than be controlled by it. It has been the American principle—and still is the principle of many people—to pay cash. This is still good, particularly in buying goods that are used up quickly.

There are times when a vacation trip, a surgical operation or medical treatment is of lasting benefit to a person even after installments to pay for it have been completed. Using credit speeds up getting items that may be great labor and time savers or that are otherwise essential to family welfare.

Families who always pay cash may unnecessarily deprive themselves of benefits available through credit. It is no disgrace to use credit, if it is used wisely.

Some rules to consider in using installment buying are:

1. Be sure that in ordinary use the article being bought will last far beyond the time the last payment is made. If families use credit intelligently they do not mortgage income of tomorrow for pleasures and comforts used up today.
2. Make as large down payments as possible without upsetting the family budget. It is generally recommended to pay down one-third of the purchase price of an automobile. For household equipment and furniture pay down at least 10 percent.
3. Pay it off as quickly as possible without making the budget too tight. No more than 24 months should be used to pay for cars, equipment and furniture.

Moderation in the signing of installment contracts is just as important as moderation in other aspects of living. Purchases bought with credit give more satisfaction if the contract is such that it is not a burden before the last payment is made. Buying on "no down payment and all the time you want" can easily get you into excessive debt.

4. Know what it costs, both in true interest rate and in actual dollars. Then you can decide if it is worth the price.

5. Understand the contract. It should tell you the cash price, credit service charge, insurance premium if any, other charges if any, down payment, allowance for trade-ins, unpaid balance, the amount of each installment payment and how often, when and where the payments are to be made. Be sure you understand the contract and that all blanks are filled in before you sign.

6. Wise use of credit includes a play for repayment. Do not agree to spend too much of monthly income to pay off installment contracts. Each of us, at a given time, has a limit beyond which we cannot obligate ourselves. The only sure way to find out that limit is to learn first how to make up an accurate, sensible personal or family budget. A budget is simply a plan for spending. The first dollars should go for basic needs like food, housing, clothing and health, and for taxes, insurance and other fixed bills or payments. There should always be some leeway for small purchases. An emergency fund is desirable and may be built up month by month.

   Plan for these first—what is left is the amount from which to pay debts, including installment payments. A carefully planned family budget will tell you, as no set formula can, how much you can safely sign up to pay.

7. Protect your credit rating. If it should be necessary to postpone or reduce scheduled payments, call on the credit manager, merchant or lender immediately. Tell him the facts as to why it is impossible to keep the payments up to date. Discuss what the future promises and what can be done to tide you over. Make every effort to carry out the changed plans that must be worked out. Your credit rating and reputation depend upon it.

Families will not get into trouble in using credit if they do these things:

1. Use it only when necessary or when the benefit justifies it.

2. Assume no more debt that they can reasonably expect to pay out of income being received now.

3. Choose the type of credit best suited to their needs.

consumer credit and our economy

The American economy is geared to a high level of use of consumer credit. If its use should be stopped abruptly the results would be far reaching. The general level of American living is higher than would be possible without consumer credit. More people of low income groups have been able to acquire articles of high value—automobiles, household equipment, television and home furnishings. Buying or investing in durable goods is a form of savings.

Mass production is possible because many people can buy the products. The economy of mass production can be and is passed on to consumers in the form of improved quality and lower prices.

Helps for Planning

Other Extension publications which may help you with your family financial decisions include Bulletin 383, "Planning Financial Security for the Family," and Bulletin 384, "Planning Family Spending." These and other helpful publications are available at your county Extension Service office.